

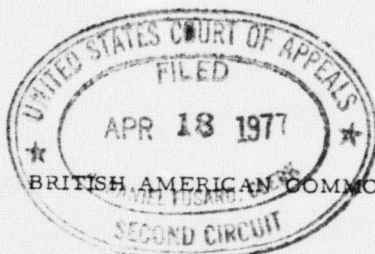
***United States Court of Appeals
for the Second Circuit***



**PETITION FOR
REHEARING**

77-6010/11

UNITED STATES COURT OF APPEALS



for the
SECOND CIRCUIT

**ORIGINAL
WITH PROOF
OF SERVICE**

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs-Appellants, Bp/s

-against-

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS, INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs-Appellants,

-against-

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING OF PLAINTIFFS-APPELLANTS
BRITISH AMERICAN COMMODITY OPTIONS CORP. AND LLOYD, CARR & CO.

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by DAVID GREENE

MARTIN KAPLAN

(6270)

PRELIMINARY STATEMENT

The undersigned, on behalf of the plaintiffs British American Commodity Options Corp. ("British American") and Lloyd, Carr & Co. ("Lloyd, Carr"), hereby submit this petition for rehearing. This decision is of widespread importance and substantial impact. Reference is made to the David Buxbaum article in the New York Law Journal, pp. 1 and 15, April 14, 1977. The industry is in an utter state of chaos and if the Court's decision is allowed to stand the virtual annihilation of the entire industry and the loss of about 5,000 to 8,000 jobs will result. Accordingly, rehearing is especially appropriate.

The plaintiffs believe that the Court made certain crucial factual assumptions which were either wrong or not supported by the record which, if remedied, would have resulted in a contrary result. The most glaring is that the Court found that prior to the regulations before it "the agency [was] confronted with a previously unregulated field" (p. 17, lines 5 and 6). This could not be further from the truth. All of the existing retail specialty dealers (approximately 70 to 100 firms), with one exception¹, were registered as commodity trading advisors ("CTA") pursuant to 7 U.S.C. § 6n.

1. British American filed its registration application in March 1976 and an administrative proceeding with respect to its application is still pending (CFTC Docket No. 76-15).

With the exception of more stringent financial requirements, which in theory these two plaintiffs have always supported, the qualifications for registration as an FCM are identical to the qualifications as a CTA. They have always been subject to all of the rules and regulations of the CFTC, including its pervasive anti-fraud rules.² Thus, during the last two years, the CFTC permitted the creation of an entirely new specialty industry, and now with "double segregation" proposes in one fell swoop unreasonably and discriminatorily to abolish such industry, leaving it to five or six large diversified securities and general commodities firms.

Secondly, the plaintiffs believe that the Court's analysis of the industry within the context of the segregation requirements was improper. The Court failed to consider the crucial distinction between an FCM who extends credit to its customers and is permitted to pledge the futures contract as collateral for a segregated account for the benefit of customers and a commodity options dealer who does not extend credit and accordingly may not use the customer's segregated account as collateral to secure the financing required to generate the funds necessary for the dealer to purchase the option for the benefit of its customer in London.

2. Reference is made to the subsequent discussion under "Registration" where the Court clearly inferred that these two plaintiffs had not diligently filed their FCM registration applications and, thus, were not in a position to question the legality and constitutionality of the registration provisions as to them individually or as to the entire industry.

The Court stated that since options are less expensive than futures contracts, options are peculiarly attractive to individual investors of relatively modest means with a propensity for taking risks. However, futures contracts are normally purchased on 5% or 10% margin and, thus, generally require a much smaller initial cash investment. Commodity futures contracts purchased on margin are far more leveraged and speculative.

The principal underlying legal basis of the Court's decision, especially as to "double segregation," appears to be that since the CFTC could have banned trading in commodity options entirely,* so long as it "considered" various alternative approaches, whatever it adopted short of abolition was neither arbitrary nor capricious. The plaintiffs are of the opinion that this approach unfortunately bypassed the serious legal questions raised as to the constitutionality of this confiscatory regulatory scheme, which is also in direct contravention of the specific anti-trust provision imposed on the CFTC by 7 U.S.C. § 19.

DOUBLE SEGREGATION

Irrespective of the Court's ruling and the basis for that ruling, one irrefutable fact stands out: all of the companies specializing in the retail sale of London commodity options which came into existence during the last two years under the CFTC's prior regulatory scheme will be required to cease operations. The Court overlooked the crucial fact that the segregated

*Such a prohibition would have been contrary to the findings of the Advisory Committee (A 110).

customer's account in the United States is not acceptable collateral.³ The purchase of the options with the dealer's funds can only be financed independently of the dealer's operations as there is no legitimate business which operates at 90% after-tax profits. The denial of the use of operating revenues for a substantial period of time would be ruinous. The Court's statement beginning at the top of page 15 that "it [double segregation] threatens to restrict participation in the industry to soundly capitalized firms" is an understatement. No one disputes that both British American and Lloyd, Carr, as well as a number of other dealers, have capital far in excess of what is required by Regulation 1.17. By its interpretation of double segregation the Court has for all practical purposes rendered the minimum financial requirements meaningless.

Since British American's present monthly volume is approximately \$2,000,000 and the average term of an option exceeds six months, as set forth in the record, it will need at least \$10,800,000 just to finance options plus additional

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3. The whole purpose of a segregated account is presumably to give the customers a first lien and the fact that the CFTC will permit the dealer to treat a portion of the segregated funds as an asset would not give a lending bank a prior lien over any potential customer's claims. Efforts to obtain financing through major broker-dealers have also proved fruitless since the enormous amounts of capital so loaned would be a charge against capital and thus could place them in violation of the SEC net capital rule and the NYSE net capital requirements.

funds to finance its operating expenses.⁴ This is far more than the "several million dollars" the Court assumed British American would be required to raise (p. 13, lines 13 and 14). A net worth of approximately \$500,000 will obviously not support a loan of almost \$12,000,000. The present level of Lloyd, Carr's sales is slightly in excess of \$1,000,000 per month; thus, requiring outside financing of approximately \$6,000,000 on a net worth of approximately \$250,000. To date they have been unsuccessful, although both companies have devoted substantial energies to this purpose and are continuing to do so. The undersigned have been contacted by other dealers, who are not parties to this suit, which have uniformly reported the unavailability of financing.

The only firms which can presently survive double segregation are the four or five largest securities firms and the three or four largest commodity houses where the retail sale of London commodity options is only a small percentage of their business. The only two firms to the undersigned's knowledge who are interested in London commodity options and have the necessary financing as of the date hereof are Shearson Hayden Stone & Co., the country's fourth largest securities dealer, which can generate sufficient funds from its other operations, to finance a limited level of retail activity, and Rosenthal & Co., a diversified futures commission merchant who, rumor has

4. The Court's conclusion that the 10% reduction would cover commissions, salaries and administrative expenses (p. 10, lines 4-7) is contrary to the record on appeal (A 553). Its sales for January and February exceeded \$2,000,000 per month.

it, has a credit line of \$75,000,000.⁵

The CFTC's justifications for double segregation with which the Court agreed are not supportable. In the first place, the imposition of double segregation, even assuming appropriate financing was available, would encourage fraud and unfair dealing, and would be prejudicial to the customer:

- (a) It would encourage naked options, which are not presently prohibited, which was the sole and/or principal cause of the Goldstein-Samuels, J.S. Love and United Kingdom situations. Obviously, if naked options are sold, the dealer is forced to recommend options on which he believes his customer will lose money in order to stay in business. The dealer is betting against the customer. Moreover, since the dealer is not transmitting the funds to buy an option in London, the adverse financial impact of double segregation is effectively avoided.
- (b) Alternatively, dealers would be required to recommend very short term options which would satisfy the best interests of the dealer in that segregated funds would be promptly released but would be generally contrary to the best interests of the customer, defeating the basic purpose of an option, to give the customer a substantial period of time in the hope of a substantial favorable price movement during the option period. An investment in commodity options is not a short term trading vehicle resulting in a substantial number of commissions to the dealer.^{6, 7}

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- 5. Shearson has insufficient capital to assist any of the 12 to 15 dealers for whom it presently clears and their present principal interest in commodity options is acting as a wholesaler. This is the same Rosenthal & Co. who consented to a preliminary injunction with respect to violations of the anti-fraud provisions of the Act (A 45). The undersigned were advised on April 17, 1977 that Rosenthal & Co. has applied for an exemption from double segregation.
 - 6. Both British American and Lloyd, Carr have taken the position that they will not sell naked options and believe that except under unusual circumstances, 30-day options are not a suitable investment vehicle from the customer's point of view.
 - 7. Under Reg. 1.17(c)(2) funds segregated with respect to options with an expiration date of a year or more are not includible as a current asset for working capital purposes (A 609).

- (c) The cost to the investor will be increased substantially, which the CFTC concedes but apparently justifies in the name of the additional protection supposedly afforded by double segregation. It is estimated that these direct costs could be in excess of \$200 per transaction.

There is not one scintilla of evidence in the record or otherwise to support the CFTC's conclusory position that double segregation will be a fraud deterrent to dealers that actually purchase the option on the ICCH and LME. The CFTC's statement that "assets [segregated in the United States] will not be subject to the attachment or other laws or requirements of any other nation," 41 Fed. Reg. 44564 (1976) [p. 13, lines 27-30] is a classic non-sequitur. From this it does not inexorably follow that the English safeguards are ineffective, especially when the record clearly shows that for over the last 100 years, there has never been a default in the fulfillment of a commodity option on the ICCH or LME.⁸ The only reference in the record is in the paragraph beginning on the bottom of page 41 of the Advisory Committee Report (A 150). The first sentence is clearly inaccurate as to the ICCH since the premium is immediately deposited in the bank and not released until the option lapses or is exercised. Counsel's statement at the March 8 public hearing, and the second sentence of that paragraph, are

8. The record does not disclose who can attach, what can be attached, and when it can be attached. Even the Advisory Committee recognized that double segregation may not protect customers or be legally effective under the bankruptcy laws (A 139, 157). In its rush to put existing dealers out of business the CFTC never attempted to obtain the appropriate legislation.

taken out of context. Everyone concedes that the London guarantees do not run directly to U.S. customers but no one disputes that the U.S. customers are the third party beneficiaries and beneficial owners of such guarantees. Securities dealers often buy and hold securities in street name, with customers as the third party beneficiaries and beneficial owners.

Obviously every business depends on sales to remain in business. Commodity options dealers will be required to obtain outside financing to remain in business because they will be denied the use of 90% of their gross sales. Double segregation violates business common sense.

There is a major inconsistency, in that for purposes of Regulation 1.19, the CFTC contends that a commodity options dealer does not "otherwise assume financial responsibility" but for purposes of Section 32.6 it is clear that such dealer must use its own funds to purchase the option in London.⁹ Thus the dealer must assume the utmost direct financial responsibility; he must purchase the option with his own funds.

REGISTRATION

The most glaring omission is the failure of the Court to consider the rights of the many individual salesmen who filed associated persons ("AP") applications, as set forth in the

9. Section 32.6 expressly provides a customer's money must be "kept in the United States".

undersigned's letter of February 15, 1977 in response to a letter from Mr. Spindel dated February 11, 1977. The CFTC has taken the position that since a number of these persons filed subsequent to December 27, 1976, they are under no obligation to promptly process their applications and have also stated in their releases that so long as such persons are not registered as APs, they cannot legally perform their jobs. In short, these persons have been deprived of the right to earn a livelihood without any hearing and in many instances, where a prior problem with the SEC, a misdemeanor or other problem exists, applicants have been advised that it will take the CFTC an additional three to six months to process the application over and above the three or four months which have already elapsed.

As heretofore discussed, the Court assumed that these firms were not registered or subject to any regulatory scheme when in fact the firms were registered as CTAs although such registration as a CTA did not require the salesmen to register as APs unless they were officers, directors, partners, 10% stockholders, or branch managers.

The Court did not discuss the serious constitutional questions as to the improper application of Section 32.3 to the two named plaintiffs. Lloyd, Carr Financial Co., d/b/a Lloyd, Carr & Co. is registered as a CTA licensed to transact commodity options. It timely filed its application as

an FCM on October 1, 1976 (A704-708). First the Commission denied that it had ever filed. But for reasons beyond its control, its application was not processed prior to January 17, 1977, and at the request of the staff it refiled an amendment thereto on January 24, 1977, merely changing the name of the applicant to Lloyd, Carr & Co. Although the only material difference between CTA and FCM registration is the minimum financial requirements, which Lloyd, Carr clearly met, its application was not granted. The tactics of the staff subsequent to January 17, 1977 and prior to February 3, 1977 in arbitrarily delaying the acceptance of such application are fully documented in the evidentiary hearing in the administrative proceeding which was conducted between March 9, 1977 and March 23, 1977. The gist of the administrative proceeding, as set forth in Exhibit "C" to the letter of the staff on February 11, 1977, submitted at the Court's request after oral argument, is that under Section 32.3, Lloyd, Carr should be put out of business, although its CTA registration had not been revoked. See 5 U.S.C. §558(c) and Pan-Atlantic Steamship Corp. v. Atlantic Coastline Railroad Co., et. al, 353 U.S. 436, 77 S.Ct. 999, 1 L.Ed. 2d 963 (1957). Since Exhibit "C" to the staff's letter failed to disclose that Lloyd, Carr Financial Co., d/b/a Lloyd, Carr & Co., had filed its FCM application on October 1, 1976, the panel misinterpreted the facts which resulted in its conclusion that since the plaintiffs had not timely filed, it could not complain as to the registration cutoff

date, as distinguished from a filing date. The position of the CFTC staff in the administrative proceeding (in which fraud was not even alleged) is that since that firm was not yet registered as an FCM, it was required to cease operations on January 17, 1977 without any hearing. This is the ultimate "Catch-22" and as the sole ground for putting someone out of business was categorically rejected in CFTC v. British American Commodity Options Corp., 422 F. Supp. 662 (S.D.N.Y. 1976).

Similarly, although the Court recognized that in December 1976 there were conflicting interpretations regarding the computation of minimum capital (which is disclosed by Form 1FR required to be filed with an FCM application), it failed to relate this to the time of filing. British American's filing in late December 1976 was caused by the concern of its accountants (also the accounting firm for Crown Colony) as to what was the proper approach as to "haircuts" (A532, 533, 534, 539-542). In short, companies are being penalized for careful consideration prior to filing rather than just putting in a piece of paper to satisfy the deadline. In this connection, it should be noted that the regulations were published on November 24, 1976 and the 60-day period "suggested" by the CFTC ends after January 17, 1977. Furthermore, from a

business point of view, the financial statement should be at the end of the month, and not during the middle of the month. November 30, 1976 is the earliest possible date with the most current information subsequent to November 24, 1976. Irrespective of this decision, they are once again saying as to British American that since they instituted an administrative hearing to deny its application as an FCM on January 14, 1977, which proceeding was consolidated on an ex parte basis with the prior CTA proceeding which is still in progress, its registration application as an FCM should be denied. Section 32.3 in theory and practice permits the CFTC to deny any firm or person its livelihood without any standards or due process. Accordingly, as to these two named plaintiffs, the Court should have enjoined the defendants from enforcing Section 32.3 because of the manner in which the CFTC has improperly applied this provision.

PROCEDURAL CLAIMS

It is respectfully submitted that in view of the scope, nature and material impact of the regulations on parties who were previously regulated by the CFTC, a fair reading of the entire record, wholly apart from the defendants' self-serving conclusions which were taken at face value, would have led to a contrary result. Citizens To Preserve Overton Park v. Volpe, 401 U.S. 402, 91 S.Ct. 814, 28 L.Ed.2d 136 (1971).

ANTITRUST ASPECTS

The holding, as well as the underlying rationale, of this Court on the legality of double segregation, are in direct conflict with the clear and unambiguous provisions of 7 U.S.C. § 19. Similarly, a substantial portion of these regulations (e.g., disclosure, minimum financial requirements, recordkeeping) violates 7 U.S.C. § 19 since the practical effect of the Court's opinion is to repeal 7 U.S.C. § 19 as to commodity options transactions. At the very minimum, it is the undersigned's opinion that this alone merits a rehearing.

SUMMARY JUDGMENT

This type of case is inappropriate for summary judgment since this Court disagreed with certain findings of fact and conclusions by the District Court on the segregation issue. There were the numerous issues of fact raised within the Court's opinion and the following are examples:

(a) Does a commodity option dealer who actually purchases the option in London "otherwise assume financial responsibility"?

(b) Is the CFTC properly processing FCM applications?

(c) Is the CFTC properly processing AP applications?

(d) Is double segregation anti-competitive?

The record clearly established that the plaintiffs met the well established criteria previously enunciated in this Circuit and the Supreme Court for a preliminary injunction. Furthermore, the Court's ruling on the plaintiffs' application for a preliminary injunction also conflicts with another circuit court. Progress Development Corporation v. Mitchell, 286 F.2d 232 (7th Cir. 1961).¹⁰

CONCLUSION

British American and Lloyd, Carr respectfully request that this Court grant the petition.

Respectfully submitted,

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Dated: New York, New York
April 17, 1977

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10. It is respectfully suggested to the panel that this case presents sufficiently serious and important questions of law relating to constitutional, antitrust, procedural, bankruptcy and administrative law, which issues may, in the panel's discretion, be appropriate for an in banc hearing.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss .

JULIO VALLEJO, JR., being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 703 REMSEN AVE.
BROOKLYN, NYC.

That on the 18 day of APRIL, 1977,
deponent personally served the within PETITION FOR REHEARING OF
PLAINTIFFS APPELLANTS BRITISH AMERICAN COMMODITY OPTIONS CORP. + LLOYD, CARR, CO.
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

By leaving true copies of same with a duly
authorized person at their designated office.

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

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Sworn to before me this

18th

day of

April

1977

Michael DeSantis
MICHAEL DeSANTIS
Notary Public, State of New York
No. 63-0930508
Qualified in Queens County
Commission Expires March 30, 1979

Julio Vallejo Jr

